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Family control, expropriation, and investor protection: A panel data analysis of Western European corporations

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ABSTRACT

We investigate whether the value impact of family control in Western European firms depends on country-level investor protection. To this aim, we account for ownership–value nonlinearities. Supporting that the risk of expropriation increases with high ownership concentration, we find an inverted U-shape relation between family control and firm value. Family firms incur a value discount when family equity holdings exceed approximately 50%. The nonlinear effect of family control is attributable to family firms from a strongly protective environment. When investor protection is weak, family control has a positive impact on firm value regardless of the ownership concentration level.

1. Introduction

Given the benefits and costs of the family business model, previous finance literature investigates whether family and non-family firms differ from each other in terms of firm performance (e.g., Anderson and Reeb, 2003; Andres, 2008; Villalonga and Amit, 2006). Some studies also provide evidence on the consequences that different types of family control (e.g., active vs. passive, founding vs. non-founding) might have for corporate performance (e.g., Bennedsen et al., 2007). Despite these efforts and although it is widely accepted that family firms are the most prevalent organizational form around the world (e.g., Claessens et al., 2000; Faccio and Lang, 2002; La Porta et al., 1999; Morck et al., 2005), thus far there is no empirical evidence on how the effect of family control on firm value depends on country-level institutional characteristics such as investor protection.

In this scenario, our objective is to investigate whether the value premium or value discount experienced by family firms as compared to their non-family counterparts depends on the level of shareholder protection that exists in a country. This issue is of particular interest because investor protection is a governance dimension that is beyond family's control. And therefore it could mitigate expropriation of minority investors' wealth by the controlling family, which is probably the most severe agency cost in family firms (e.g., Claessens et al., 2002; Masulis et al., 2011). Although retaining family control can be optimal where minority investors' rights are not well protected (Burkart et al., 2003), by the same token it can be negative for minority outside investors, whose wealth can be more easily expropriated. To disentangle whether investor protection curbs the risk of expropriation in

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family firms, we examine how the shareholder protection rules interact with family control among Western European corporations to determine firm value.

Western Europe is the perfect "laboratory" for our study because Western European countries share the same cultural background and are governed within the framework established by supra-national institutions, which ensures some degree of homogeneity in terms of economic objectives. But at the same time, there is substantial heterogeneity across countries along the investor protection dimension, which makes this region especially suitable for our analyses. Additionally, although family control is prevalent among Western European corporations (Faccio and Lang, 2002), the evolution of family ownership depends on country-level factors (Franks et al., 2012).

To investigate the impact of investor protection on the relation between family control and firm value, we need to control for the three possible sources of endogeneity (Wooldridge, 2010). First, we alleviate endogeneity concerns driven by unobservable heterogeneity that remains constant over time and may affect both ownership structure and firm value (Bloom and van Reenen, 2007; Mura, 2007) by using a panel data estimator. Second, we address the reverse causality problem using suitable lagged values of the explanatory variables as instruments following the approach proposed by Blundell and Bond (1998) when deriving the system generalized method of moments (GMM). As Wintoki et al. (2012) highlight, an important aspect of the GMM method is that it enables us to overcome the difficulty of finding external factors or natural experiments by relying on a set of "internal" instruments contained within the panel itself. And third, we mitigate the problem of measurement error in our main explanatory variable (i.e., the family nature of a business) using several ownership concentration thresholds in all our analyses to identify family firms.

To test our hypotheses, we focus on how ownership concentration affects firm value consistent with previous seminal research (Demsetz and Lehn, 1985). We then interact ownership concentration with a family dummy to disentangle the performance difference of family firms. Our initial results support the beneficial effect of family control for firm performance in Western Europe. But this effect might depend on the size of the family stake in the company. For this reason, we estimate a nonlinear relation and confirm that ownership concentration and firm value are nonlinearly related regardless of owner type. Nevertheless, the ability and incentives of controlling families to expropriate may depend on how strong minority investors' rights are protected by the law. Therefore, we extend the nonlinear specification including two-way interaction terms that let us divide family firms in two categories depending on whether they operate in strongly or in weakly protective countries. Our findings confirm an inverted U-shape between family control and firm value in more protective environments. When investor protection is weak, family control impacts positively on firm value regardless of the ownership concentration level.

We contribute to the corporate finance and governance literature by examining the interaction between family control and the legal system in an effort to disentangle how investor protection rules influence the risk of expropriation by controlling families. In this respect, our study provides new empirical evidence on the relevance of considering the institutional environment when analyzing the implications of family control for firm performance. The main conclusion of the paper is that country-level investor protection shapes the relation between family control and firm value. Specifically, the different performance of family firms depends on the level of family control and on the strength of minority shareholder protection afforded by the law.

Our study helps clarify the evolution of family ownership documented by Franks et al. (2012). These authors show that a country's level of shareholder protection is a factor that explains to what extent family ownership constitutes the predominant organizational form. Our empirical evidence suggests that investor protection determines the prevalence of family firms indirectly by affecting the family effect on firm performance. The beneficial effect of family control for firms' market valuations in weakly protective environments partly explains the survival of the family business model in this scenario.

In addition to complementing the recent study by Franks et al. (2012), our paper is closely related to other research. La Porta et al. (2002) and Lins (2003) investigate the impact of ownership structure and investor protection on firm valuation. More recently, Laeven and Levine (2008) study the relation between firm valuation and ownership dispersion across multiple owners. Unlike these previous studies, our emphasis is on family control, which is the most prevalent ownership type in Western Europe. Moreover, although La Porta et al. (2002) analyze the interaction effect of a firm's ownership structure and investor protection on firm value, they do not find any significant joint impact. Compared to Lins (2003), who analyzes managerial entrenchment, we investigate shareholder expropriation, which is the predominant agency problem in regions with concentrated ownership structures. Our work also differs from Laeven and Levine's (2008) investigation in that their main focus is on ownership dispersion and not on owner identity. A significant difference of our approach is that we examine how investor protection affects expropriation incentives of a specific shareholder type (controlling families) accounting for the widely supported nonlinearities between the ownership structure and firm value.

The remainder of the paper is organized as follows. The next section reviews the previous theoretical and empirical literature related to family control, and presents our hypotheses. Section 3 describes the data and details the family firm definition used in the study. Section 4 discusses the choice of the estimation method. Section 5 presents some descriptive analyses as well as the empirical approach adopted and the regression results obtained. Section 6 includes several robustness checks that reinforce our findings. The last section highlights the main conclusions.

2. Literature review and hypothesis development

Earlier studies suggest that the monitoring role of large investors can in part resolve the classic owner–manager problem, which would lead to a positive impact from ownership concentration on firm performance (see, e.g., Jensen and Meckling, 1976). Contrary to this view, Demsetz (1983) argues that there should be no significant relation between ownership structure and performance because the former should be influenced by the profit-maximizing behavior of shareholders. This argument proposes that a firm's ownership structure could be endogenously determined, among other factors, by corporate performance.